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Securities industry developments - 1999/2000; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Securities Industry Developments— 1999/2000

Complement to AICPA Audit and Accounting Guide
Audits of Brokers and Dealers in Securities

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, this year's Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well. This document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

The staff of the AICPA is grateful to the Stockbrokerage and Investment Banking Committee and the securities and commodity futures regulatory staffs for their contributions to this document. Also, the staff is thankful to the U.S. department of the Treasury for providing the information on money laundering contained in this document.

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Accounting and Auditing Publications

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Industry and Economic Developments

What significant industry and economic developments are relevant to the audits of broker-dealers and commodity entities?

The growth of the U.S. economy in recent years continued in 1999. The current period of expansion, the second longest in history, will break the record of one hundred and six months if the expansion continues into early next year. The global economy also showed some signs of improvement through the first three quarters of 1999 following ominous economic news in 1998. Take a look at some of the specific economic statistics and developments during the past year.

- The Federal Reserve raised its federal funds rate, the rate at which banks lend to each other overnight, from 4.75 percent to 5 percent in June, followed by a second increase in August to 5.25 percent.
- In March 1999, the Dow Jones Industrial Average (DJIA) closed at 10,000 for the first time, just three and a half years after reaching its first close above 5,000. Soon after reaching 10,000, the DJIA passed 11,000. It did not remain above this level, however, because the equities market displayed periods of volatility during 1999. For example, during a one-week period in September 1999, the DJIA lost over 500 points, ending the week at just under 10,300. The National Association of Securities Dealers Automated Quotation (NASDAQ) composite fell nearly 130 points during that same week.
- Inflation remained low at about 2 1/2 percent.
- Emerging market currencies, following a turbulent 1998, settled into a quieter period through the third quarter of 1999.

The favorable profit performance of the securities industry in recent years continued through the first and second quarters of 1999. Merger and acquisition activity, which had escalated steadily during the past few years, continued to remain strong in 1999, including global merger and acquisition activity. Underwriting activity did not meet the record levels experienced in 1998, but nevertheless continued to remain strong in 1999.

Despite the positive economic factors in 1999, there were some indications of difficulties by both individual and corporate borrowers in meeting payments for their debt obligations. Also, not all sectors of the economy were equal benefactors of the current economic prosperity.

Chapter 5, "Auditing Considerations", in the Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide) emphasizes that before the start of the audit, the auditor should review the guidance in Statement of Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), regarding specific procedures that should be considered in planning an audit in accordance with a generally accepted auditing standards (GAAS). The planning process includes gaining an understanding of the business and consideration of other important factors that affect the broker-dealer, including external economic factors.

The particular circumstances of each audit will likely affect the nature and extent of the information regarding external economic factors that needs to be considered. This determination may depend on, among other things, the particular products and services provided by the broker-dealer, the nature of the broker-dealer's customers, and the environment in which the broker-dealer operates.

During the past year, the securities industry has undergone significant changes that have resulted from technological development. Overall, spending for information technology has increased as broker-dealers continue to make the technological improvements needed to meet the demands of increased trading volumes and the development of electronic commerce, including the need to operate effectively using the Internet.

The Impact of Technology and Electronic Commerce

How have technology and electronic commerce affected broker-dealers and the securities industry? One area is online trading. The rapid growth in the number of online brokerage accounts in the United States experienced in the past few years continued in 1999. More full service brokers also have begun to offer this service, which was initially embraced mostly by discount brokerage firms. A number of brokerage firms offering online stock trading services have increased online offerings to retail customers to also include fixed income products. Also, in some instances, online trading has resulted in changes in the commission and product pricing structures for some broker-dealers. See the discussion entitled "Online Brokerage" in the "Audit and Attestation Issues and Developments" section of this Audit Risk Alert for additional information.

Another result of technological development is the growing number of alternative trading systems (ATS). ATS include electronic communication networks (ECN), which match buyers and sellers in securities for a commission. The ECN themselves do not commit capital to facilitate trading. Originally used by institutional investors, ECN are increasingly being used for the retail market. In December 1998, the Securities and Exchange Commission (SEC) adopted final rules allowing ATS to choose whether to register as national securities exchanges or as broker-dealers complying with additional requirements. This SEC final rule is discussed in the "Regulatory Developments" section of this Audit Risk Alert.

The development of ECN has resulted in increased opportunities for extended trading hours, or after-hours trading beyond the current trading hours of the traditional stock exchanges. In addition to the after-hours trading opportunities offered by the ECN, traditional exchanges have made plans to offer after-hours trading. The SEC, National Association of Securities Dealers (NASD), New York Stock Exchange (NYSE), along with other representatives from the securities industry and consumer groups, have established working groups to address the issue of after-hours trading, including the following:

- Investor protection and education, including educating investors about the risks and rewards of after-hours trading

- Clearance, settlement, and operations, including back-office issues, such as the calculation of net margin and systems implications
- Trading conventions, the dissemination of market data, trading halts for corporate news and other developments, and intermarket trading rules
- Options market issues, coordination with the stock markets, dissemination of options market data, back office issues, and the effects on exercise and settlement procedures

One of the matters to be considered by auditors is whether conditions arising from these technological changes will increase audit risk. For example, as stated in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), rapidly changing technology may represent a fraud risk factor. The auditor's professional responsibilities in this regard are set forth in SAS No. 82. SAS No. 82 provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 provides examples of the risk factors that relate to misstatements arising from fraudulent financial reporting.

> **Help Desk**—For further information on fraud, refer to the AICPA Practice Aid, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk), which walks the practitioner through the issues likely to be encountered in applying SAS No. 82 and provides valuable tools, such as sample documentation. It also provides specific guidance on applying the concepts of the Statement to broker-dealers.

New systems or technology also may have implications with regard to broker-dealers and their internal control. Auditors should obtain a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS. Among other things, the Statement states that risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change as a result of circumstances such as the following:

- Changes in the operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Corporate restructurings
- Foreign operations
- Accounting pronoucements

Auditors should be alert to the implications on the internal control of their broker-dealer clients in circumstances such as those noted above. In addition, consider SAS No. 60, *Communications of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which provides guidance in identifying and reporting conditions that relate to a broker-dealer's internal control observed during an audit of financial statements.

Auditors of broker-dealers investing in ECN may wish to consider the guidance in SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332). SAS No. 81 provides guidance to auditors in auditing investments in debt and equity securities investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. See "On the Horizon," later in this Audit Risk Alert, regarding the proposed Statement on Auditing Standards that would supersede SAS No. 81.

Technological developments in the securities industry have affected not only broker-dealers but also their customers. Customers now have access to information on their security investments and other financial information through a variety of sources, including numerous Web sites. Pricing information on security investments can be accessed throughout the day through the Internet, Internet-ready cell phones, and other wireless sources such as pagers or personal digital assistants. Software programs are available that enable customers to prepare technical financial analyses. A number of wireless devices have been developed that enable investors to place trades using a pager.

Broker-dealers, in seeking to meet the challenges of the current environment, may be experiencing increased competitive pressures to develop new pricing strategies or to change established methods for delivering services to clients. A number of broker-dealers have been exploring the opportunities to provide services to customers via nontraditional channels. For example, investment banks have begun offering investment banking services via the Internet, providing customers with expanded access to initial public offerings (IPO). Some broker-dealers have been changing the nature of products provided to customers who prefer to take a more active role in managing their own securities investments. In meeting these competitive pressures, broker-dealers may be required to significantly modify existing processing systems or to develop new processing systems that will be able to meet people's increased expectations of information processing. Additionally, new products that can be increasingly complex and sophisticated may be developed to meet customer needs or to effect trading strategies. New personnel may be required or existing personnel may require additional training to properly service and account for new products, lines of business or services, as well as to implement and maintain new systems.

Europe's Economic and Monetary Union

On January 1, 1999, financial markets in the eleven European nations of the European Union's Economic and Monetary Union (EMU) began trading securities in the euro, the new single eurocurrency that it has created. Cross-country exchange rates between the eleven member nations no longer exist, and only one rate is published—national rates to the euro. See the discussion entitled "The Euro in the Audit and Attestation Issues and Developments" of this Audit Risk Alert for additional information on this issue.

The Commodities Industry

In recent years, the lines between the securities and commodities industries have become less distinct. Broker-dealers frequently function in areas that are subject to regulation by the Commodity Futures Trading Commission (CFTC). They may deal in commodity and financial futures or advise and operate entities (pools) that do so. To conduct such activities, they must register with the CFTC as futures commission merchants (FCM), introducing brokers (IB), commodity pool operators (CPO), or commodity trading advisers (CTA). The 1983 Shad-Johnson Accord between the SEC and the CFTC delineated the areas of each agency's authority for different financial products.

Rapid advances in technology and a number of alliances among the world's trading exchanges have radically changed the picture for the commodities industry in the past several years. Responding to increased competition, many commodities firms are focusing more of their attention and effort on reducing costs and retaining customers. Traditional outcry trading on commodity exchange floors is being challenged by trading on electronic exchange platforms. This development may influence the value of memberships in exchanges that use open outcry trading. For a discussion of the audit implications related to the value of exchange memberships, see the discussion entitled "Value of Commodity Exchange Memberships" in the "Audit and Attestation Issues and Developments" section of this Audit Risk Alert.

The volume of futures and options contracts traded bears directly on the revenues of commodity brokers. Futures and options trading amounted to 309.5 million contracts for the first half of 1999, slightly below the first six months of 1998. A number of experts anticipate that if this trend in volume holds for the balance of 1999 and commission rates do not deteriorate, the level of commission income for commodity brokers in 1999 should be comparable to the record-setting level of 1998.

Executive Summary—Industry and Economic Developments

- The growth of the U.S. economy in recent years continued in 1999. The current period of expansion, the second longest in history, will break the record of one hundred and six months if the expansion continues into early next year.
- During the past year, the securities industry has undergone significant changes resulting from technological developments. Auditors should be alert to the implications of such changes on the risk of material misstatement that result from fraud.
- Broker-dealers, in seeking to meet the challenges of the current environment, may be experiencing increased competitive pressures, and, as a result, have been exploring the opportunities to provide services to customers via nontraditional channels. New systems or technology, new personnel, or new products or activities can affect the operations of the broker-dealer and its internal control.
- Rapid advances in technology and a number of alliances among the world's trading exchanges have radically changed the picture for the commodities industry over the past several years. Responding to increased competition, many commodities firms are focusing more of their attention and effort on reducing costs and retaining customers.

Regulatory Developments

What are some of the regulatory developments affecting the securities industry?

Chapter 5 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor might not otherwise do so.

The audit and reporting requirements for securities broker-dealers are regulated by rule 17a-5 under the Securities Exchange Act of 1934 (the 1934 Act). An alternative regulatory framework has been created for over-the-counter derivatives dealers that establish a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. Registered broker-dealers in U.S. government securities are regulated by section 405.02 of the regulations pursuant to section 15C of the Exchange Act.

Qualifications and reports of independent accountants of commodity entities are specified by Regulation 1.16 the Commodity Exchange Act (CEA).

Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

Securities and Exchange Commission Regulations

What are some of the final rules issued by the Securities and Exchange Commission during 1999?

The following is a summary of some of the rules the SEC issued during 1999.

- *Segment reporting.* The SEC approved technical amendments to rules 3-03 and 12-16 of Regulation S-X, Items 101 and 102 of Regulation S-K, and Schedule 14A. The amendments conform SEC segment reporting requirements to the requirements adopted by the Financial Accounting Standards Board (FASB) in Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information.* Certain requirements relating to disclosure of principal products or services and major customers that traditionally have differed from FASB Standards have been retained. The amendments also address rule changes related to disclosure requirements for geographic areas and segment information added to interim reports. The effective date is February 11, 1999.

- *Form S-8.* The SEC adopted amendments to Form S-8 that restrict the use of Form S-8 for the offer and sale of securities to consultants and advisers and allow the use of Form S-8 for the exercise of stock options by family members of employee optionees. The effective date is April 7, 1999.

- *Exempt offerings pursuant to compensatory arrangements.* The SEC adopted amendments to rule 701 under the Securities Exchange Act of 1933 (the 1933 Act) that provides an exemption from registration for securities issued by nonreporting companies pursuant to compensatory arrangements. Rule 701 allows private companies to sell securities to their employees without filing a registration statement, a requirement that applies to public companies. The rule provides an exemption from the registration requirements of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The amendments make rule 701 more useful and eliminate unnecessary restrictions. The effective date is April 7, 1999.

- *Rule 504 of Regulation D.* The SEC adopted amendments to rule 504 of Regulation D. Rule 504 provides an exemption from Securities Act Registration for securities offerings of nonreporting companies that do not exceed an aggregate annual amount of one million dollars. Rule 504 permits a nonreporting issuer to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information in a public offering. Rule 504 has been modified to limit the circumstances in which general solicitation is permitted and "freely tradable" securities may be issued in reliance on the rule. The effective date is April 7, 1999.

- *Rule 3a12-8 exempt securities.* The SEC adopted amendments to rule 3a12-8 adding Sweden and Belgium to the list of countries whose debt obligations are exempted by rule 3a12-8. Rule 3a12-8 was adopted under the 1933 Act to designate debt obligations issued by certain foreign governments as exempted securities under the Exchange Act solely for the purpose of marketing and trading futures contracts on those securities in the United States. The effective dates are June 2, 1999 (for Sweden) and March 5, 1999 (for Belgium).
- *Broker-dealer registration and reporting—Form BDW.* The SEC amended Form BDW and related filing procedures under the Exchange Act to implement changes recommended to allow filings from the World Wide Web. Form BDW is required to be used by all broker-dealers that seek to withdraw from registration with the SEC. The amendments clarify Form BDW and its filing procedures and also adopt other minor rule revisions relating to the status of Form BDW as a report under the Exchange Act and when a filed Form BDW becomes effective. The effective date is June 9, 1999.
- *EDGAR System.* The SEC adopted amendments to its rules governing the Electronic Data Gathering and Retrieval (EDGAR) System that are intended to make the EDGAR System easier for filers to use, and to make documents more readable for public users. The rule amendments reflect initial changes to filing requirements resulting from the SEC's EDGAR modernization project as well as other changes clarifying or updating SEC rules. Under the final rules, the SEC will accept filings submitted to EDGAR in HyperText Markup Language (HTML) in addition to documents submitted in the American Standard Code for Information Interchange (ASCII) format. Filers will have the option of accompanying their required filings with unofficial copies in Portable Document Format (PDF). The effective date is June 28, 1999. The SEC also adopted an updated edition of the EDGAR Filer Manual and provided for its incorporation by reference into the Code of Federal Regulations (CFR). The effective date is October 18, 1999.

- *Broker-dealer registration and reporting—Form BD.* The SEC amended Form BD, the uniform broker-dealer registration form and related rules under the Exchange Act. The amendments are mainly technical and formatting changes needed to accommodate electronic filing in "Web CRD," the new Internet-based Central Registration Depository system, a computer system operated by the NASD that maintains registration information regarding broker-dealers and their registered personnel. The effective date is July 30, 1999.

- *Operational capability requirements.* The SEC adopted temporary rules 15b7-3T, 17AD-21T, and 17a-9T under the Exchange Act, effective August 30, 1999. Rules 15b7-3T and 17Ad-21T require registered broker-dealers and non-bank transfer agents to ensure that their mission-critical computer systems are year 2000 compliant by August 31, 1999, or to certify that any material year 2000 problems in mission-critical systems will be fixed no later than November 15, 1999. Rule 17a9-T requires certain broker-dealers to make and preserve a separate trade blotter and securities record or ledger as of the close of business of the last three business days of 1999. These rules are intended to reduce the risk to investors and the securities markets posed by broker-dealers that have not adequately prepared their computer systems for the millennium transition. The effective date is August 30, 1999. See the discussion entitled "The Year 2000 Issue" in the "Audit and Attestation Issues and Developments" section of this Audit Risk Alert for additional information on the Year 2000 Issue.

- *Amendment to rule 10b-18.* The SEC amended rule 10b-18 under the 1934 Act. Rule 10b-18 provides a "safe harbor" from liability for manipulation under Sections 9(a)(2) and 10(b) of the 1934 Act, and rule 10b-5 thereunder. In order to improve liquidity during severe market downturns, the amendment modifies the rule's timing condition during the trading session immediately following a market-wide trading suspension.

In December 1998, the SEC issued the following two final rules which became effective in 1999.

- *Alternative trading systems.* The SEC adopted new rules and rule amendments to allow alternative trading systems to choose whether to register as national securities exchanges, or to register as broker-dealers and comply with additional requirements under Regulation ATS, depending on their activities and trading volume. The SEC also adopted amendments to rules regarding registration as a national securities exchange; repealed rule 17a-23, previously adopted to provide information about the activities of automated markets operated by broker-dealers; and amended the books and records rules by transferring the recordkeeping requirements from rule 17a-23 to rules 17a-3 and 17a-4 as they apply to broker-dealer internal trading systems. The SEC excluded from the rule filing requirements for self-regulatory organizations (SRO) certain pilot trading systems operated by national securities exchanges and national securities associations. The effective date is April 21, 1999, except for rule 301(b)(5)(I)(D) and (E), and rule 301(b)(6)(I)(D) and (E), which is effective on April 1, 2000, and rule 301(b)(3), with various effective dates.
- *New derivative securities products.* The SEC adopted an amendment to rule 19b-4 under the 1934 Act to permit SRO to list and trade new derivative securities products pursuant to existing SRO trading rules, procedures, surveillance programs and listing standards without submitting a proposed rule change pursuant to section 19(b) of the Exchange Act. The SEC also amended rule 19b-4 to expand the scope of SRO matters that do not constitute proposed rule changes. The effective date is February 22, 1999.

Help Desk—The complete text of the above rules, along with other SEC final rules, including those rules adopted, or changes made, subsequent to the publication of this Audit Risk Alert, can be downloaded from the SEC's Web site at www.sec.gov.

Other Recent Securities and Exchange Commission Developments

Moratorium on Certain New Rulemaking

The SEC imposed a moratorium from June 1, 1999, until March 31, 2000, on the implementation of any rulemaking that would require major computer reprogramming by SEC-regulated entities to allow firms to concentrate on year 2000 remediation efforts and testing.

Soft Dollar Arrangements

In September 1998, the SEC released the results of the SEC Office of Compliance Inspections and Examination's series of sweep examinations of soft dollar arrangements, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisors and Mutual Funds*. The SEC has defined soft dollar practices as arrangements in which products or services other than the execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer. The report describes the results of an examination the SEC conducted of on-site inspections of the soft dollar practices of seventy-five broker-dealers and two hundred eighty investment advisors and investment companies. The report includes examination findings for broker-dealers, as well as for investment companies and investment advisers, including the identification of payments that were not made in accordance with the SEC's interpretations of arrangements that are covered by section 28(e) of the 1934 Act, which governs soft dollar transactions. The report also included the following four recommendations, noting that the SEC should—

- Reiterate guidance with respect to the section 28(e) safe harbor for "brokerage and research services" provided through the use of soft dollars.
- Consider adopting recordkeeping requirements that provide greater accountability for soft dollar transactions and allocations.

- Modify Form ADV to require more meaningful soft dollar disclosure.
- Encourage advisers to strengthen their internal control procedures relating to soft dollar activities.

Securities and Exchange Commission Staff Accounting Bulletin No. 99, *Materiality*

The SEC staff released Staff Accounting Bulletin (SAB) No. 99, *Materiality*, which addresses the application of materiality thresholds to the preparation and audit of financial statements that are filed with the SEC.[1] The SAB reaffirms concepts of materiality as expressed in accounting and auditing literature as well as long-standing case law. It advises auditors not to rely on arbitrary numerical benchmarks in assessing materiality and the need to consider qualitative factors. For more information on the SAB, see the AICPA *General Audit Risk Alert 1999/2000* or view the full text of the SAB at the SEC Web site at www.sec.gov/rules/acctreps/sab99.htm.

Commodity Futures Trading Commission Regulations

What are some of the final rules issued by the Commodity Futures Trading Commission during 1999?

The following is a summary of some of the final rules issued by the CFTC during 1999.

- *Recordkeeping requirements.* As part of its continuing program to update its rules, the CFTC adopted amendments to the recordkeeping requirements contained in its regulations, C.F.R. section 1.31, to allow recordkeepers to store most categories of required records on either micrographic or electronic storage media for the full five-year maintenance period. The effective dates are June 28, 1999, and September 27, 1999.

[1] SABs are not rules or interpretations of the SEC; they represent interpretations and practices followed by staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

- *Registration, exemption, and disclosure regarding trading foreign futures and option contracts.* The CFTC amended rule 30.5 so that foreign IB, CPO, and CTA could obtain exemptions to solicit any customers within the United States after filing the appropriate petition. A petitioner would be required to show that the petitioner is located outside the United States; not subject to the rules of a designated contract market in the United States; and that the petitioner consented to the jurisdiction in the United States with respect to transactions subject to Part 30 of the regulations promulgated under the CEA. The amendments to rule 30.6 were adopted to level the playing field by requiring uniform disclosures to U.S. clients or pool participants by IB, CPO, and CTA regardless of whether trading on domestic or foreign exchanges, including uniform disclosures that must be made to sophisticated investors. In addition, the CFTC issued an order delegating to the National Futures Association (NFA) the authority to review disclosure documents filed pursuant to the amended rules. The NFA adopted rule 2-35 containing its requirements for such disclosure documents. The effective date is June 28, 1999.
- *Contract applications.* The CFTC issued final rules that reduced the burden on U.S. futures exchanges associated with applying for approval of new contracts. Five pages of rules in the CFR were replaced with three separate, user-friendly application forms that apply to physical delivery futures contracts, cash-settled futures contracts, and option contracts. The application forms make use of charts or checklists to significantly reduce the paperwork burden on U.S. exchanges in applying for CFTC approval of new futures and options contracts. In addition, the new application forms reduce paperwork by permitting exchanges to use third-party generated written materials in support of the applications, and eliminate unnecessary narrative information. The exchanges can download the application forms from the CFTC's Web site and submit completed applications electronically. The effective date is August 2, 1999.

Also, the following final rules that were issued by the CFTC in 1998 became effective in 1999.

- *Exemptive, no-action, and interpretative letters.* The CFTC adopted new Regulation 140.99, which establishes procedures for submitting requests to CFTC staff for exemptive, no-action, and interpretative letters. The effective date is January 11, 1999.
- *Use of two-part disclosure documents for commodity pools.* CFTC Regulation 4.24 was amended to require, among other things, that the CPO of a commodity pool that is not required to register its securities under the 1933 Act (private pool) must prepare and distribute a Disclosure Document, written using plain English principles and limited to specific disclosure information required by rules 4.24 and 4.25. In addition, the CPO may prepare and distribute a Statement of Additional Information (SAI) which may include information that is not in the Disclosure Document, provided that the information is not misleading or otherwise inconsistent with applicable statutes, rules or regulations. The effective date is April 30, 1999.

Help Desk—The complete text of the preceding rules, along with other CFTC final rules, including those rules adopted, or changes made, subsequent to the publication of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

What are the significant issues raised in the most recent "Dear CPO" letter?

The staff of the CFTC issued a letter, dated February 10, 1999, addressed to CPO and their independent public accountants outlining key reporting issues. The letter pointed out the CFTC staff's concerns and accordingly may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. The following summary highlights and updates some of the areas of concern cited in the "Dear CPO" letter.

- *Filing reports in a timely manner.* For each pool that a CPO operates, regulation 4.22(c) *[4.7(a)(2)(iii) or 4.12(b)(2)(iii)]* requires the CPO to provide an annual report to investors, to the CFTC (two copies) and to the NFA within ninety days of the CPO's fiscal year-end. CPO are strongly encouraged to file one additional copy of the annual report with the appropriate CFTC regional office. Regulation 4.22(c) further requires that a CPO notify the CFTC by the end of January if it did not operate any commodity pools during the preceding year[2]. If a CPO needs an extension of time to file a pool's annual report, it should make such a request to NFA before the due date of the report and file a copy of the request with the Division of Trading and Markets at the CFTC's Washington headquarters office. The request must comply with the requirements of regulation 4.22(f), which are discussed in CFTC Advisory No. 87-1. Except in the case of "funds of funds," extensions are granted only upon a showing of unusual extenuating circumstances. Moreover, extensions of more than forty-five days are rarely, if ever, granted.
- *Disproportionate share of net income.* CFTC Interpretative Letter No. 94-3, *Special Allocations of Investment Partnership Equity*, describes the procedures for reporting special allocations of partnership equity from limited partners to the general partner. These special allocations must be recognized in the same period as the net income or other basis of computation; classified in the income statement as either an expense or a special allocation of net income; separately reported in the statement of partnership equity; and deducted in the computation of net performance and rate-of-return information. The Interpretative Letter also applies to pools filing under Regulations 4.7 or 4.12. The CFTC staff found that these special allocations were often only shown in the statement of changes in partners' capital

[2] If a pool ceases operations during the year, an audited report must be provided within ninety days of the permanent cessation of trading, but by no later than ninety days after all funds have been returned to pool participants.

or discussed in notes and were not being reported on the face of the income statement in accordance with regulation 4.22(e) and the Interpretative Letter. To provide meaningful disclosure, the income statement of a commodity pool must show an investor the amount available to all investors, net of preferential allocations.

- *Information concerning net asset values.* Regulation 4.22(c)(2) requires that a pool's annual report include either the net asset value per outstanding participation unit in the pool as of the end of the current and preceding fiscal years, or the total value of each participant's interest or share in the pool as of the end of the current and preceding years. This information need not be included in the annual report for a rule 4.7 pool if it has already been provided in a separate fourth quarter report to participants and is not required for a pool with a rule 4.12 exemption. The CFTC staff found that the net asset value information was frequently missing.

- *Oath or affirmation by CPO.* Regulation 4.22(h) *[4.7(a)(2)(iii)(A) or 4.12(b)(iii)(A)]* requires that each annual report include a signed oath or affirmation. The CFTC staff found that the oath or affirmation was frequently missing or there was no signature on the line provided for a signature. Many CPO incorrectly believe that the oath is required only with the regulators' copy of the financial report. A signed oath, or a copy thereof, is required to be distributed with every copy of a financial report, including those to each participant or potential participant.

- *Subsequent events.* Regulation 4.22(c)(5) *[4.7(a)(2)(iii)(3) or 4.12(b)(2)(iii)]* states that a pool's annual report must contain appropriate footnote disclosure and further material information as may be necessary to make the required statements not misleading. The CFTC staff interprets these regulations to require that significant changes in performance between the date of the financial statements and their issuance to investors be reported in notes to the financial statements.

- *Fund of funds considerations.* In recent years, there has been an increase in the number of "fund of funds" arrangements, in which one pool (investor pool) invests its assets in another pool (called the *investee pool*) rather than directly in futures, options, or securities. In a number of these arrangements, the investor pool has invested a significant amount of its assets in one or more investee pools. The degree of investment raises financial reporting issues for these investor pools. If the investor pool has invested substantially all of its assets in a single investee pool, the financial statements of that investee pool should be included with those of the investor pool. At a minimum, an investor pool should disclose the following:
  - Name of the pool
  - Carrying value of the investment
  - Liquidity information (such as limitations on withdrawals from the investee pool)
  - Summary income statement information in the format required under Regulation 4.22(e), including fees paid by the investee pool to the investee pool's CPO and CTAs
- The above information should be disclosed to investor pool participants so that they are aware of the nature of their pool's investments and risks. Once determined that a pool has a major investee pool or a series of investments which exceed 10 percent of the investor pool's equity, the disclosures are required, except that item (I) can be omitted for grouped, individually non-major investments. The disclosures are required for all investments in other investment companies, whether or not those investees are commodity pools.
- *Organization costs.* Occasionally, a limited partnership agreement of a pool provides that organization costs be repaid to the pool's general partner from the pool's interest income. In such a case, the amounts should not be netted, but shown separately in the statement of income.

Self-Regulatory Organization Regulations

What are some of the final rules issued by the self-regulatory organizations during 1999?

Under the 1934 Act, all broker-dealers are required to be members of SRO such as the NYSE or the NASD that perform routine surveillance and monitoring of their members. During the past year, the SEC also approved various NYSE and NASD rules and rule amendments. Among these were the following.

- *Proprietary accounts of an introducing broker.* NYSE Interpretation Memo 98-10 extends the requirement to perform a Customer Reserve Computation with respect to proprietary accounts of introducing brokers (PAIB accounts) carried by their clearing brokers in order for the introducing broker to receive allowable asset treatment under rule 15c3-1 for proprietary assets held at their clearing broker. The introducing broker and its clearing broker must agree in writing to perform the PAIB reserve calculation under the methodology outlined in the no action letter attached to the Interpretation Memo. Auditors should be alert to additional audit procedures that may be required by the regulators with respect to the correspondent brokers.
- *Confirmation and affirmation of securities transactions.* In May 1999, the SEC approved a rule change requested by the Municipal Securities Rulemaking Board (MSRB), the NASD, and the NYSE that will allow qualified vendors that receive SEC permission to provide confirmation and affirmation services for delivery-versus-payment or receive-versus-payment trades for institutional customers even though they are not registered clearing agencies.
- *Carrying agreements.* In June 1999, the SEC approved a rule change that amends NYSE rule 382 relating to introducing/carrying agreements. The effective date is July 19, 1999, with certain requirements phased in. Auditors should refer to the full text of these and other rules issued by the SROs. The amendments—

- Provide for increased monitoring and reporting of customer complaints regarding introducing organizations.
- Require specific procedures for exception-type reports offered to introducing organizations by carrying organizations.
- Address procedures dealing with introducing organizations that are permitted to issue negotiable instruments directly from their carrying organizations.

Audit and Attestation Issues and Developments

The Year 2000 Issue

What are some of the developments that have taken place in the last year with respect to the Year 2000 Issue?

The Year 2000 Issue is not a recent development. Nevertheless, the securities industry has maintained a significant focus on this issue during the past year as January 1, 2000, approaches. Briefly, the Year 2000 Issue relates to the inability of many electronic data processing (EDP) systems to accurately process year-date data beyond the year 1999 because of the long-standing practice of designing computer programs to store dates in the date/month/year (dd/mm/yy) format, thus allowing only two digits for each component. Such programs will recognize the date January 1, 2000 (01/01/00) as January 1, 1900, and process data incorrectly or perhaps not at all.

Industry and Regulatory Developments

The SEC's broker-dealer year 2000 monitoring program has the following three elements.

- *Direct monitoring.* In 1998, the SEC adopted a temporary rule requiring certain broker-dealers to file two reports on their year 2000 progress. These reports have been reviewed by the SEC staff to identify firm-specific Year 2000 Issues.

- *Collaboration with self-regulatory organizations.* The SEC has worked with the SROs to monitor broker-dealer progress and ensure that systems are appropriately tested.
- *Industry testing.* The Securities Industry Association (SIA) coordinated an industry-wide test in March and April of 1999. Almost four hundred brokerage firms, mutual funds, and service bureaus participated as well as U.S. Securities Exchanges, the NASDAQ , clearing agencies, and the Depository Trust Corporation. The industry-wide test revealed only four year 2000 problems out of more than 250,000 test results, and those problems were quickly fixed. The SEC continued to work with the Securities Industry Association (SIA), other federal regulators and the securities industry to complete further year 2000 testing.

The Futures Industry Association (FIA) also conducted industry-wide tests during 1999 that included participation by clearing member firms and all futures exchanges.

The SEC adopted temporary rules 15b7-3T, 17AD-21T and 17a-9T under the Exchange Act, effective August 30, 1999. Rules 15b7-3T and 17Ad-21T require registered broker-dealers to ensure that their mission-critical computer systems are year 2000 compliant by August 31, 1999, or to certify that any material year 2000 problems in mission-critical systems will be fixed no later than November 15, 1999. Rule 17a9-T requires certain broker-dealers to make and preserve a separate trade blotter and securities record or ledger as of the close of business of the last three business days of 1999. These rules are intended to reduce the risk to investors and the securities markets posed by broker-dealers that have not adequately prepared their computer systems for the millennium transition. The full text of the final rules are available on the SEC Web site at www.sec.gov.

The CFTC, in Advisory 24-99, addressed contingency planning, the final phase of year 2000 preparation. Advisory 24-99 provides FCM, IB, CPO, and CTA with guidance concerning the need to make appropriate plans to address business continuity issues. These registrants must have a written contingency plan no later than September 1, 1999 that must be provided to the CFTC and the registrant's self-regulator upon request.

Auditing Issues

Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A comprehensive discussion of these considerations can be found in the AICPA general *General Audit Risk Alert—1999/2000.*

In addition, the AICPA continues to be active in creating awareness of the Year 2000 Issue among its members and the public and providing guidance to auditors regarding their responsibilities in audits leading up to the year 2000 through published books, articles, and other materials, including the following.

- The AICPA publication *The Year 2000 Issue—Current Accounting and Auditing Guidance* provides a wealth of information for auditors including discussions related to the following:
  - Introduction to and implications of the Year 2000 Issue
  - Industry-specific considerations
  - Financial reporting issues
  - Auditing issues
  - Disclosure considerations
  - Auditor communications
  - Practice management issues
- The AICPA Web site at www.aicpa.org/members/y2000/intro.htm is a resource page that contains useful links to various Web sites and publications with additional information on the Year 2000 Issue. Additional information from other sources relating to the Year 2000 Issue is available on the Internet at the following Web sites:
  - The Securities Industry Association (SIA)—www.sia.com/year_2000/index.html

– The National Bulletin Board for the year 2000—www.year2000.com

Executive Summary—The Year 2000 Issue

- The Year 2000 Issue relates to the inability of many EDP systems to accurately process year-date data beyond the year 1999. Some programs may recognize the date January 1, 2000 (01/01/00) as January 1, 1900 or perhaps not at all.
- The SEC, CFTC, AICPA, and industry trade groups have taken various measures to guide broker-dealers and their auditors in their preparations for the year 2000.
- Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, revenue and expense recognition, and disclosure.

Online Brokerage

What should auditors consider when auditing trades in an online environment?

The main difference between an online trade and a traditional trade is the lack of a middleman, that is, the customer, instead of a broker, types in the order for an online trade. In both forms of trading, an order is entered into the computer system, which then transmits it to a stock exchange or NASDAQ for execution. Traditional source documents, such as purchase orders, invoices, and checks, are replaced by electronic communications. Auditors should carefully consider the internal controls related to these communications as well as the nature and sufficiency of available evidential matter underlying trading transactions.

SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically.

SAS No. 31, as amended by SAS No. 80, states that the auditor's specific objectives are the same whether information is processed manually or electronically. Nevertheless, the methods of applying audit procedures to gather evidence may be influenced by the method of processing. In entities in which significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is neither practical or possible to reduce the detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for the improper initiation or alteration of information to occur and not be detected will be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk or considering the effect on the auditor's report.

The SAS further states that in certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Certain electronic evidence may exist at a certain point in time. Such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of the auditor's substantive tests, and if applicable, tests of controls.

> **Help Desk**—The AICPA Auditing Procedure Study (APS), entitled *The Information Technology Age: Evidential Matter in the Electronic Environment,* provides auditors with nonauthoritative guidance on implementing SAS No. 31. The APS describes electronic evidence and its implications and presents two case studies that illustrate various audit approaches. Other relevant APSs include *Audit Implications of EDI and Audit Implications of Electronic Document Management.* Auditors also may wish to obtain additional information from the Information Systems Audit and Control Association's Web site at www.isaca.org.

New Accounts

What are the implications of increased volumes of new accounts?

Broker-dealers have experienced large increases in the numbers of new accounts opened for customers. Control and monitoring activities for opening and maintaining new accounts are essential for broker-dealers. Paragraph 6.37 of the Audit and Accounting Guide *Brokers and Dealers in Securities* provides examples of the activities that should be followed by broker-dealers in connection with the opening of new accounts.

The growth in new accounts and in trading activity may result in an increase in transactional activity and outstanding balances for customer receivables and payables. Chapter 5 of the Guide provides examples of substantive tests and tests of controls for customer receivables and payables which would include determining the following.

- Appropriate customer approvals are obtained for new accounts.
- Trading and other activity is adequately monitored.
- Procedures for monitoring and resolving customer complaints are adequate.
- Reserves are sufficient relative to exposure.
- Exposure and reserve amounts for undermargined, partly secured, and unsecured customer accounts.

The auditor should review customers' accounts for evidence of undermargined, partly secured, or unsecured conditions that may affect the net capital computation under SEC rule 15c3-1 and the reserve and possession-or-control requirements of rule 15c3-3, as well as the collectibility of accounts.

The Euro

What are some of the audit issues relating to the EMU's adoption of the euro?

The introduction of the euro was a significant event, but one that is still unfolding. During a transition period extending through

January 1, 2002, business transactions with the eleven nations that thusfar constitute the EMU can be settled in either legacy currencies or the euro. Euro notes and coins will be issued at the end of the transition period, and by June 30, 2002, all the legacy currencies—currencies of the eleven EMU nations—will be obsolete. As a result of the euro, broker-dealers have needed to implement system changes necessary to begin trading in this new currency.

SAS No. 55, as amended by SAS No. 78, provides guidance on the independent auditor's consideration of an entity's internal control in an audit of the financial statements in accordance with GAAS. SAS No. 55 states, among other matters, that the auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The auditor should be alert for risks that can arise or change as a result of circumstances such as new systems or system changes.

Auditors may need to address the impact of the euro conversion on the comparability of financial information when performing analytical review procedures, for example, in the examination of foreign exchange revenues (for example, reductions in certain cross-currency exchange revenues), operating costs, or investments. SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of the audit. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.

Independence Standards

What is the Independence Standards Board? What new rules has the Independence Standards Board issued?

The Independence Standards Board (ISB) was established in 1997 as part of an agreement between the AICPA and the SEC to establish and improve standards relating to auditor independence for SEC registrants. The ISB also provides guidance to practitioners regarding independence matters. The SEC recognized the ISB as an authoritative rulemaker on questions of auditor independence in Financial Reporting Release No. 50.

ISB pronouncements apply to auditors of domestic and foreign registrants. ISB pronouncements would also apply where a regulatory agency undertakes to have auditors of entities under its jurisdiction comply with SEC Independence Rules. Also, an auditor might contractually obligate himself to follow SEC Regulation S-X. An example might be a private company intending to have a public offering in the future and the desire of management to have the auditor meet all SEC requirements.

The functioning of the ISB does not affect the authority of state licensing or disciplinary authorities regarding auditor independence. Also, it does not affect the AICPA rules on independence as they relate to audits of nonpublic entities. The second general standard (AICPA, *Professional Standards*, vol. 1, AU sec. 150.02) of GAAS requires that in all matters relating to the audit engagement, an independence in mental attitude is to be maintained by the auditor. SAS No.1, AU section 220.03 provides that "...to be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners."

In 1999, the ISB issued its first statement, ISB Standard No. 1, *Independence Discussions with Audit Committees.* To address implementation issues relative to ISB Standard No. 1, the AIPCA's Professional Issues Task Force developed Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees.* The Practice Alert is designed to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may bear on the auditor's independence. This Practice Alert may be obtained from the AICPA Web site at www.aicpa.org.

One of the developments that has highlighted the awareness of independence issues is the increase in opportunities for independent accountants to perform nonaudit services, such as consulting services, for audit clients. One area in which auditors of broker-dealers may be providing consulting services for broker-dealers is the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This accounting standard should significantly affect broker-dealers. The ISB, in addition to this first independence standard, issued Interpretation 99-1, *Impact on Auditor Independence of Assisting in the Implementation of FAS 133 (Derivatives)*. This Interpretation provides guidance on auditor independence implications related to FASB Statement No. 133.

The Interpretation concludes that the auditor may provide consulting services on the proper application of FASB Statement No. 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure that the auditor's independence is not threatened, as discussed in paragraph 4 of the Interpretation, the auditor may not prepare accounting entries, compute derivative values, or be responsible for key assumptions or inputs used by the client in computing derivative values.

Additional discussion of independence considerations can be found in the AICPA *General Audit Risk Alert—1999/2000*.

Additional information on the activities of the ISB is available in the ISB Web site at www.cpaindependence.org.

Value of Commodity Exchange Memberships

What are the audit issues relating to the value of commodity exchange memberships?

During the past year, the value of U.S. commodity exchange memberships continued to fluctuate, although all remained significantly below their historical highs. Although declines in the value of exchange memberships do not affect regulatory net capital, because exchange memberships are excluded from the net capital calculation, such declines continue to raise concerns about the value of such assets reported in financial statements prepared in accordance with generally accepted accounting principles (GAAP).

When addressing valuations of exchange memberships, auditors should evaluate management's consideration of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.* FASB Statement No. 121 states in part that a significant decrease in the market value of an asset indicates that the recoverability of the carrying value of that asset should be assessed. It further states that quoted market prices in active markets are the best evidence of fair value and should be used as the basis of measurement, if available. Exchange memberships are bought and sold continuously. Paragraph 7.34 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* states that exchange memberships owned by a broker-dealer and held for operating purposes should be valued at cost or at a lesser amount if there is an other-than-temporary impairment in value. The AICPA Practice Aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools,* describes the same accounting treatment. In light of the volatility in the prices of exchange memberships as shown in the following table, the auditor may wish to consider whether management has valued them correctly.

Price of Exchange Memberships

	December 1997	**December 1998**	**Recent Price**	**Date**
Chicago Board of Trade	$724,950	$485,000	$450,000	October 27, 1999
Commodity Exchange Inc.	$ 93,000	$ 62,500	$ 82,000	October 15, 1999
Chicago Mercantile Exchange	$466,667	$295,000	$550,000	October 27, 1999

(continued)

Price of Exchange Memberships

	December 1997	December 1998	Recent Price	Date
Coffee, Sugar, Cocoa Exchange	$180,000	$ 97,000	$131,000	October 15, 1999
New York Cotton Exchange	$125,000	$ 65,000	$ 73,000	October 4, 1999
New York Mercantile Exchange	$675,000	$590,000	$575,000	October 26, 1999

Money Laundering Activities and the Auditor's Consideration of Illegal Acts[3]

What is money laundering? What are the auditor's responsibilities with respect to money laundering?

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdictions. Current estimates of the size of the global annual "gross money laundering product" range from $300 billion to $1 trillion.[4]

Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S. Department of the Treasury, brokers and dealers in securities may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, new technologies, and new distribution channels—generate important business opportunities, but they also generate risks for securities firms and their auditors, including increased vulnerability

[3] The U.S. Department of Treasury has had significant input in drafting the content of this section of the Alert. As such, it provides auditors of securities firms with a unique insight into how federal regulators view this important area of concern.

[4] By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

to money laundering. As these industry trends continue, as money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings. In addition, as greater regulatory requirements for banks and other nonbank financial institutions make it more difficult for them to evade detection, the securities industry may become more attractive to money launderers.

Although money laundering activity and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes—placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law-enforcement strategies and techniques to keep their proceeds concealed, their methods secret, and their professional resources anonymous. A most common placement technique is the structuring[5] of cash deposits into legitimate financial institution accounts, converting cash into other monetary instruments, and using these instruments to make investments. Another important placement technique is customers' making large deposits and investments with laundered proceeds in the form of monetary instruments, bearer securities, or third-party checks.

Layering is the process of generating a series of or layers of transactions to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include electronic funds transfers, usually directly or subsequently transacted with a "bank secrecy haven" or a jurisdiction with more liberal recordkeeping and reporting requirements; withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders and travelers

[5] *Structuring* means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner as to avoid suspicion and detection.

checks; and requests for account transfers or checks made payable to third parties with whom the account holder appears to have no obvious relationship.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions.

Money launderers tend to use the victimized business entity as a conduit for illicit funds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, money laundering is less likely to be detected in a financial statement audit than other types of illegal activities. In addition, money laundering activity is more likely to cause assets to be overstated rather than understated, with shorter term fluctuations in account balances rather than cumulative changes. Money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317). Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

A description of federal regulations pertaining to money laundering appears in the appendix, entitled "Federal Regulations Related to Money Laundering," of this Audit Risk Alert.

Executive Summary—Money Laundering Activities and the Auditor's Consideration of Illegal Acts

- Money laundering is a global activity in which cash or other funds from illegal activities are funneled through legitimate businesses to conceal the initial source of funds.
- Money laundering usually results in large amounts of illicit proceeds that need to be distanced from their source as quickly as possible and is less likely to be detected in a financial statement audit than other types of illegal activities.
- Under SAS No. 54, money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. The auditor does not have a detection responsibility for such illegal acts. However, auditors should be aware of the possibility that such illegal acts may have occurred.

FASB Statement No. 133 and Hedge Accounting Topics

Presented below are discussions about some topics related to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and hedge accounting that you may find useful.

Formal Documentation Under FASB Statement No. 133

Upon adoption of FASB Statement No. 133, an entity is required to designate all hedging relationships anew and must comply with the formal documentation requirements of the standard as of the date of adoption. The standard stresses the need for the formal documentation to be prepared contemporaneously with the designation of the hedging relationship. The items the formal documentation must identify include the following:

- The entity's risk management objectives and strategies for undertaking the hedge
- The nature of the hedged risk
- The derivative hedging instrument
- The hedged forecasted transaction
- A description of how the entity will assess hedge effectiveness

When the hedged item is a forecasted transaction, the documentation of the hedged item must be sufficiently specific such that when a transaction occurs, it is clear whether or not that particular transaction is the hedged transaction. The documentation also must specify the method to be used for assessing hedge effectiveness. FASB Statement No. 133 requires that an entity use the chosen method consistently throughout the hedge period to (a) assess, at inception of the hedge and on an on-going basis, whether it expects the hedging relationship to be highly effective in achieving offset and (b) determine hedge ineffectiveness. The SEC staff has challenged the appropriateness of hedge accounting when registrants have not complied with FASB Statement No. 133's formal documentation requirements.

Hedge Accounting Issues

For companies that have not yet adopted FASB Statement No. 133, guidance related to hedge accounting includes FASB Statement No. 80, *Accounting for Futures Contracts*, and EITF Topic D-64, *Accounting for Derivatives Used to Hedge Interest Rate Risk.* You may also want to familiarize yourself with the following reminders about macro hedging and hedging with intercompany derivatives.

Macro Hedging. Under FASB Statement No. 80 (and as outlined in EITF Topic D-64), macro hedging is not permitted. Under FASB Statement No. 80, hedge criteria include the following:

- Designation of a derivative instrument to an individual item or group of essentially similar items
- The probability of a high correlation of changes in the market value of the futures contract(s) and the fair value of or interest income or expense associated with the hedged item(s)
- Enterprise risk reduction

Hedging With Intercompany Derivatives. Fundamental to FASB Statement No. 80's enterprise risk reduction model is that the derivative hedging instrument be transacted with an unrelated third party. For any intercompany derivative instrument designated as a hedging instrument after January 1, 1999, there must exist documentation, prepared contemporaneously, which demonstrates that the notional amount, duration, interest rate risk, currency risk, commodity risk, and other risks associated with such intercompany derivative contracts have been layed off to unrelated third parties. For intercompany derivative contracts designated after January 1, 1999, that do not meet these requirements, an entity should eliminate their impact in preparing consolidated financial statements in accordance with ARB No. 51, *Consolidated Financial Statements.* In addition, these intercompany derivative contracts will not qualify as hedging instruments in the consolidated financial statements.

Executive Summary—FASB Statement No. 133 and Hedge Accounting Topics

- The SEC staff has challenged the appropriateness of hedge accounting if registrants have not complied with FASB Statement No. 133's formal documentation requirements.
- For entities that have not yet adopted FASB Statement No. 133, guidance related to hedge accounting includes FASB Statement No. 80 and EITF Topic D-64.
- Under FASB Statement No. 80 (and as outlined in EITF Topic D-64), macro hedging is not permitted.
- For any intercompany derivative instrument designated as a hedging instrument after January 1, 1999, there must exist documentation, prepared contemporaneously, which demonstrates that the notional amount, duration, interest rate risk, currency risk, commodity risk, and other risks associated with such intercompany derivative contracts have been layed off to unrelated third parties.

Accounting for Restructuring Charges

EITF Guidance and Having a Management Plan

Combining entities often restructure their operations. Auditors should consider whether management has appropriately accounted for restructuring costs in accordance with the requirements of EITF Issue Nos. 94-3, *Liability Recognition for Certain*

Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring), and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*. To justify such charges, an approved management plan as of the date of the financial statements should exist. Management's plan must be comprehensive, explicit, and adequately documented to provide objective evidence of management's intent. The SEC staff has interpreted the literature governing special charges literally, particularly the requirements relating to the existence of a comprehensive documented plan that has been approved by the appropriate level of management.

Loss recognition that is based on management's intent must be supported by objective evidence of intent. To demonstrate management's intent, the SEC staff considers whether the plan is sufficiently developed to forecast its consequences and management's commitment to ultimately implement the plan as contemplated. Therefore it is imperative that a documented and appropriately approved management plan that is comprehensive and explicit exists to accrue a liability.

Making Required Disclosures

When liabilities are accrued in accordance with the guidance in EITF Issue Nos. 94-3 and 95-3, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity or involuntarily terminate employees of an acquired company have been fully executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

Making Sure Accruals Are Not "Cushions"

The SEC staff has observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be "providing a cushion" in establishing such reserves. When reviewing management's accruals, you should be aware of the kinds of charges that are allowed to be accrued for, pursuant to EITF Issue Nos. 94-3 and 95-3, and other relevant accounting literature, as appropriate.

In addition, the SEC staff has stated that liabilities accrued in accordance with EITF Issue Nos. 94-3 and 95-3 are valuation accounts that should be disclosed on Schedule VIII, Valuation and Qualifying Accounts, of SEC registrants' annual reports filed on Form 10-K.

Executive Summary—Accounting for Restructuring Charges

- Auditors should consider whether management has appropriately accounted for restructuring costs in accordance with the requirements of EITF Issue Nos. 94-3 and 95-3.
- If restructuring charges are incurred, a comprehensive, documented management plan, approved by an appropriate level of management should exist.
- When disclosure thresholds have been met under EITF Issue Nos. 94-3 and 95-3, all the disclosures are required, not just those that are individually met.
- The SEC staff has observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be "providing a cushion" in establishing such reserves.

SEC-Related Accounting and Auditing Topics

What are some topics that the SEC may be focusing on?

Presented below are discussions of certain matters provided by the SEC staff that are relevant to broker-dealers and the securities industry.

Use of Allowances for Credit Losses for Trading Activities

GAAP requires that trading account assets be recorded on the balance sheet at fair value with changes in fair value reported in trading income each reporting period. The SEC staff has noted instances in which registrants have recorded allowances for credit losses for trading account assets. In such cases, the registrants have asserted that pricing adjustments are required to bring derivative instruments in the trading portfolio to their fair value. In such cases, the SEC staff has indicated that registrants should determine pricing adjustments based on a consistently applied review of specific trading counterparties and the credit risk affecting fair value associated with each. Additionally, GAAP requires that such pricing adjustments and subsequent changes therein be reported with other amounts related to the trading account. That is, fair value pricing adjustments should be reported as an adjustment to trading account assets and not through an allowance for credit losses. Periodic increases or decreases in the adjustment necessary to measure the assets at fair value should be reported as part of income from trading activities.

Determining Fair Value of Trading Assets

Under paragraph 5 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Quoted market prices, if available, are the best evidence of the fair value of a financial instrument. If a quoted market price is available for an instrument, the fair value of the instrument is the product of the number of trading units of the instrument times the quoted market price. Accordingly, quoted market prices should not be adjusted for large block factors. If a quoted market price is not available, fair value should be based on the best information available in the circumstances. FASB Statement No.107 and the AICPA Audit and Accounting Guide Brokers and Dealers in Securities, among other sources, provide additional information about determining the fair value of a financial instrument.

Segment Information

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information,* requires companies to report financial and descriptive information about their reportable operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available, and that is evaluated regularly by the "chief operating decision maker" in deciding how to allocate resources and to assess segment performance. The AICPA Auditing Standards Board has issued guidance (see AICPA *Professional Standards* AU section 326, *Evidential Matter*) requiring, among other things, that auditors "review corroborating evidence, such as information that the chief operating decision maker uses to assess performance and allocate resources, material presented to the board of directors, minutes from the meetings of the board of directors, and information that management provides in management's discussion and analysis (MD&A), to financial analysts, and in the Chairman's letter to shareholders, for consistency with financial statement disclosures."

The SEC staff has noted that, in some cases, financial statements of public companies have not conformed with the requirements of FASB Statement No. 131. The staff has seen instances in which: (1) the internal reporting package included operating information on more segments than were disclosed in the financial statements; (2) those additional segments were discussed in MD&A or analysts' reports; and (3) the company's executives also discussed the additional segments in press releases or business periodicals.

When reviewing segment information as part of its normal filing review and comment process, the SEC staff may ask registrants for a copy of the internal reports or other materials supplied to the "chief operating decision maker" of the company, as well as analysts' reports and press releases. Assuring quality implementation of FASB Statement No. 131 on segment disclosures is clearly in the interest of investors. Consequently, if the segment information provided in the financial statements does not reflect a similar breakdown of company segments as is evident in the internal reports and other materials, the SEC staff will seek amendment of the registrant's filings.

Executive Summary—SEC-Related Accounting and Auditing Topics

- Fair value pricing adjustments should be reported as an adjustment to trading account assets and not through an allowance for credit losses. Periodic increases or decreases in the adjustment necessary to measure the assets at fair value should be reported as part of income from trading activities.
- When determining the fair value of a financial instrument, quoted market prices should not be adjusted for large block factors. If a quoted market price is not available, fair value should be based on the best information available in the circumstances.
- The SEC staff has noted that, in some cases, financial statements of public companies have not conformed with the requirements of FASB Statement No. 131.
- If segment information provided in the financial statements does not reflect a similar breakdown of company segments as is evident in a company's internal reports, analysts's reports, press releases, and other materials, the SEC staff will seek amendment of the registrant's filings.

New Audit and Attestation Standards

What new audit and attestation standards has the AICPA issued in the past year which can affect broker-dealers?

In this section, we present brief summaries of recently issued auditing and attestation pronouncements. The summaries are for informational purposes only, and should not be relied on as a substitute for a complete reading of the applicable standard.

As of the writing of this Audit Risk Alert, no new Statements on Auditing Standards had been issued during 1999. For a discussion of the outstanding exposure drafts for proposed SASs, see the discussion entitled "Auditing Standards Board Exposure Drafts Outstanding" in the "On the Horizon" section of this Audit Risk Alert.

Also, as a reminder, SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), became effective for reports issued after December 31, 1998.

The Statement provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, the elements to include in that report. Appendix B, "Amendment to Paragraph 12 of Statement on Auditing Standards No. 60, *Communication of Integral Control Related Matters Noted in an Audit*," of this Statement includes a list of illustrative auditors' reports in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* that require conforming changes as a result of the guidance in SAS No. 87.

SSAE No. 9

SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3* (AICPA, *Professional Standards*, vol. 1, AT secs. 100, 400, and 500), was issued by the ASB in January 1999. SSAE No. 9 amends SSAE No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100); SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400); and SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500). Although practitioners are still permitted to report on management's assertion, SSAE No. 9 provides practitioners with the option of reporting directly on the subject matter of the assertion. SSAE No. 9 also conforms the reporting guidance in the aforementioned SSAEs to include similar reporting elements to those in audit reports on historical financial statements, and provides guidance on the relationship between the SSAEs and the statements on quality control standards. SSAE No. 9 is effective for reports issued on or after June 30, 1999.

AICPA Accounting and Auditing Literature

Audit and Accounting Guide

The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (Product No. 012181kk) has been modified to include certain changes necessary as a result of the issuance of authoritative pronouncements through May 1, 1999. Copies may be obtained by calling the AICPA Order Department at (888) 777-7077 or by faxing a request to (800) 362-5066.

AICPA Practice Aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*

The AICPA Practice Aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (Product No. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of FCM, IB, and commodity pools. Organized to complement the AICPA Audit and Accounting Guide Guide *Brokers and Dealers in Securities*, this practice aid includes discussions of a commodity industry overview, regulatory considerations, auditing considerations and accounting standards, in addition to illustrative financial statements of FCM and IB. Copies may be obtained by calling the AICPA Order Department at (888) 777-7077 or by faxing a request to (800) 362-5066.

AICPA reSOURCE

AICPA reSOURCE provides electronic access to AICPA *Professional Standards*, Technical Practice Aids, and Audit and Accounting Guides. AICPA reSOURCE CD-ROM provides access to this AICPA audit and accounting literature on CD-ROM. AICPA reSOURCE Online provides online access to AICPA audit and accounting literature. AICPA reSOURCE CD-ROM and AICPA reSOURCE Online are available by subscription. Subscription to AICPA reSOURCE Online is available through the AICPA Web site at www.aicpa.org. AICPA reSOURCE CD-ROM may be obtained by calling the AICPA Member Satisfaction Center at (888) 777-7077.

Accounting Issues and Developments

New FASB Pronouncements

What new accounting standards has the FASB issued in 1999 which can affect broker-dealers[6]?

In this section, we present brief summaries of recently issued accounting pronouncements. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard.

Technical Corrections

FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, was issued in February 1999 and is effective for financial statements issued for fiscal years ending after February 15, 1999. FASB Statement No. 135 amends existing authoritative literature to make various technical corrections, clarify meanings, or describe applicability under changed conditions. FASB Statement No. 135 also rescinds FASB Statement No. 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units.*

Accounting for Derivatives

FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, was issued in June 1999. This Statement delays the effective date of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, for one year to fiscal years beginning after June 15, 2000, and is applicable to both quarterly and annual financial statements. FASB Statement No. 133 established the accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities.

[6] This section of this Audit Risk Alert summarizes the new FASB pronouncements issued in 1999 through FASB Statement No. 137 that may affect broker-dealers. Auditors should refer to the full text of these accounting pronouncements. For a comprehensive listing of accounting pronouncements issued this year, see the AICPA General Audit Risk Alert—1999/2000.

FASB Statement No. 125 Developments

What are some of the recent developments relating to FASB Statement No. 125?

After the issuance of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in June 1996, the FASB received a high volume of inquiries on the implementation of this Statement. A Special Report, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, was issued by the FASB staff to aid in the understanding and implementation of FASB Statement No. 125. The first edition of the Special Report was published in September 1998, followed by a second edition, published in December 1998, and a third edition, published in July 1999. The Special Report is organized in a question and answer format. The second and third editions of the report are cumulative documents, incorporating new questions and answers with questions and answers from previous editions.

The FASB issued an exposure draft of a proposed FASB Statement, *Accounting for Transfers of Financial Assets (an amendment of FASB Statement No. 125)*, for comment in June 1999. The FASB also issued an exposure draft of a proposed Technical Bulletin, *Classification and Measurement of Financial Assets Securitized Using a Special-Purpose Entity*, for comment in August 1999. For additional discussion of these exposure drafts see the discussion entitled "FASB Exposure Drafts Outstanding," in the section "On the Horizon" of this Audit Risk Alert.

Consolidation of Special Purpose Entities

An issue frequently encountered related to securitizations of financial assets is the consolidation of a special purpose entity (SPE). Specifically, a question arises regarding the appropriate accounting guidance that should be referred to when determining whether an SPE used in securitizing financial assets should be consolidated. The answer depends on whether or not the SPE is a qualifying SPE, or QSPE, (as defined in FASB Statement No. 125). If the SPE is a QSPE, the transferor must follow the guidance in EITF Issue 96-20, *Impact of FASB Statement No. 125 on*

Consolidation of Special-Purpose Entities. For all other SPEs, a transferor (or sponsor or creator, as applicable) should continue to apply the consolidation criteria of EITF Topic D-14, *Transactions Involving Special-Purpose Entities*, and Issue 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, as appropriate. Among the requirements of Topic D-14 and Issue 90-15 are that an SPE must have an initial substantive residual equity capital investment (3 percent at a minimum), and that investment must represent an equity interest in legal form and must be subordinate to all debt interests.

Reporting on the Costs of Start-Up Activities

As a reminder, SOP 98-5, *Reporting on the Costs of Start-Up Activities*, became effective for financial statements for fiscal years beginning after December 15, 1998. This SOP provides guidance on the financial reporting of start-up costs and organization costs, requiring these costs to be expensed as incurred. The SOP defines start-up activities as those one-time activities relating to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operation.

On the Horizon

FASB Exposure Drafts Outstanding[7]

What are some of the outstanding exposure drafts that have been released by the FASB for comment?

Consolidated Financial Statements

The FASB issued an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements—Purpose and Policy*, for

[7] This section of the Audit Risk Alert discusses some of the exposure drafts that have been released by the FASB for comment and which are outstanding as of the writing of this Audit Risk Alert. Auditors should be alert for the issuance of a final statement or interpretation or other developments related to these FASB projects. Further information related to these and other FASB projects can be obtained from the FASB Web site at www.fasb.org.

comment in February 1999. This proposed Statement would establish standards for determining when entities should be included in consolidated financial statements. The proposed Statement would apply to business enterprises and not-for-profit organizations that control entities regardless of the legal form of controlling and controlled entities. The proposed Statement would not apply to financial statements of certain reporting entities such as pension plans and investment companies that carry substantially all of their assets at fair value with all changes in value reported in a statement of net income. The proposed Statement would require that a controlling entity consolidate all entities that it controls unless control is temporary at the time the entity becomes a subsidiary. The proposed Statement would supersede or amend various accounting pronouncements and would be effective for financial statements for annual periods beginning after December 15, 1999, and for all interim periods in the year of adoption, with earlier application encouraged.

Exposure Draft—Transfers of Financial Assets

The FASB issued an exposure draft of a proposed FASB Statement, *Accounting for Transfers of Financial Assets (an amendment of FASB Statement No. 125)*, for comment in June 1999. This proposed Statement would amend FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to—

- Clarify the criteria and expand the guidance for determining when the transferor has extinguished control and the transfer is therefore accounted for as a sale.
- Adopt new accounting requirements for pledged collateral.
- Require new disclosures about securitizations and pledged collateral.

The proposed Statements includes various effective dates.

Stock Compensation

The FASB issued an exposure draft of a proposed Interpretation of *Accounting Principles Board Opinion* (APB) No. 25, *Accounting for Stock Issued to Employees*, for comment in March 1999. The proposed Interpretation, *Accounting for Certain Transactions involving Stock Compensation (an interpretation of APB Opinion No. 25)*, focuses on several practice issues identified as needing clarification by the FASB.

Financial Assets

The FASB issued an exposure draft of a proposed Technical Bulletin, *Classification and Measurement of Financial Assets Securitized Using a Special-Purpose Entity*, for comment in August 1999. The proposed Technical Bulletin would provide guidance on accounting for financial assets securitized using a special-purpose entity.

Auditing Standards Board Exposure Drafts Outstanding[8]

What are some of the outstanding exposure drafts for proposed Statements on Auditing Standards that have been released for comment by the Auditing Standards Board?

Omnibus Statement on Auditing Standards

The Auditing Standards Board (ASB) issued an exposure draft of a proposed SAS entitled *Audit Adjustments, Reporting on Consistency, and Service Organizations (Omnibus Statement on Auditing Standards—1999)*. The proposed Statement provides guidance to auditors in the following three areas—

- Management's responsibility for the disposition of financial statement misstatements brought to its attention

[8] Note: This section of the Audit Risk Alert discusses some of the exposure drafts that have been released by the ASB for comment and which are outstanding at the publication date of this Audit Risk Alert. Auditors should be alert for the issuance of any final pronouncements or other developments related to these ASB projects. Further information related to these and other ASB projects can be obtained from the AICPA Web site at www.aicpa.org.

- Changes in the reporting entity that require a consistency explanatory paragraph in the auditor's report
- Determining whether information about a service organization's controls is needed to plan the audit

After issuance of the exposure draft, the ASB decided to issue the Reporting on Consistency and Service Organizations guidance together in one SAS and issue the Audit Adjustments guidance in a separate SAS. The expected issuance date for the final SASs is December 1999.

Auditing Financial Instruments

The ASB issued an exposure draft of a proposed SAS, *Auditing Financial Instruments.* The proposed SAS would supersede SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and provide updated guidance on planning and performing auditing procedures for financial statement assertions about financial instruments. The ASB also plans to issue a practice aid to help auditors implement this proposed SAS.

Amendments to SAS No. 61 and 71

The ASB issued an exposure draft of a proposed SAS, *Amendments to Statements on Auditing Standard No. 61*, Communication with Audit Committees and Statement on Auditing Standards No. 71, *Interim Financial Information.* The "Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" was released in March 1999. For additional information on this report, see the discussion entitled "Audit Committee Oversight" in this section of this Audit Risk Alert. This report included recommendations suggesting changes to GAAS. In response, the ASB established the Audit Committee Effectiveness Task Force to address the report's recommendations. As a result of the Committee's recommendations, and in conjunction with actions expected to be taken by NYSE, NASD, and the SEC, in a collaborative effort to improve audit committee effectiveness, the task force reviewed SAS No. 61, *Communication With Audit Committees*

(AICPA, *Professional Standards*, vol. 1, AU sec. 380), and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to determine whether these sections should be amended to reflect recommendations 8 and 10. The ASB has issued an exposure draft of proposed amendments to SAS Nos. 61 and 71 that are responsive to the recommendations. If approved, the amendments would become effective for fiscal and calendar years beginning in 2000.

Audit Committee Oversight

What are the recent developments regarding audit committee oversight?

At the request of the SEC to consider ways that audit committees' effectiveness could be enhanced, the NASD and the NYSE sponsored a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon Committee). The Blue Ribbon Committee published recommendations in February 1999 in the "Report and Recommendations of the Blue Ribbon Committee on Improving Effectiveness of Corporate Audit Committees." This report can be found online on the NASD and NYSE Web sites at www.nasd.com or www.nyse.com. A summary of the Blue Ribbon Committee recommendations follows.

The first two recommendations aim to strengthen the independence of audit committees.

- *Recommendation 1.* The NASD and NYSE should adopt a definition of independence for listed companies with market capitalization greater than $200 million or other appropriate identified measure.[9] Members of the audit committee shall be considered independent if they have no relationships to the corporation that may interfere with the exercise of their independence from the management of the corporation. Examples of such relationships are provided.

[9] The NYSE is recommending that this exemption be eliminated. This decision was based on the COSO fraud report finding that most fraud occurs in small companies with market capitalization well below $200 million.

- *Recommendation 2.* The NASD and NYSE should require that listed companies with market capitalization of greater than $200 million or other appropriate identified measure—have an audit committee comprised solely of independent directors.[10]

The next three recommendations are aimed at making audit committees more effective.

- *Recommendation 3.* The NASD and NYSE should require that listed companies with market capitalization greater than $200 million or other appropriate identified measure have an audit committee comprised of a minimum of three directors, each of whom is financially literate.

- *Recommendation 4.* The NASD and NYSE should require that the audit committee of each listed company adopt a formal written charter that is approved by the board of directors and review and reassess the adequacy of the charter on an annual basis.

- *Recommendation 5.* The SEC should promulgate rules that require the audit committee to disclose in the proxy statement for its annual shareholder meeting whether the audit committee has adopted a formal written charter and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter.

The final group of recommendations address accountability mechanisms.

- *Recommendation 6.* The NYSE and NASD should require that audit committee charters for listed companies specify that the outside auditor is ultimately accountable to the board of directors and the audit committee as representatives of shareholders.

- *Recommendation 7.* The NYSE and NASD should require that the audit committee charter for listed companies specify that the audit committee is responsible for ensuring the

[10] ibid.

receipt of a formal written statement from the outside auditors delineating all relationships between the auditor and the company consistent with Independence Standards Board Statement 1. The audit committee also is responsible for engaging in active dialogue with the auditor with respect to any disclosed relationships or services that may affect objectivity or independence.

- *Recommendation 8.* GAAS should require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality of the company's accounting principles as applied to financial reporting.
- *Recommendation 9.* The SEC should require all reporting companies to include a letter from the audit committee to shareholders in the company's annual report and in Form 10-K annual report disclosing whether or not—
  - Management reviewed the audited financial statements with the audit committee, including the quality of the accounting principles applied and significant judgments affecting the financial statements.
  - Outside auditors have discussed their judgments of the quality of those principles as applied with the audit committee.
  - Members of the audit committee have discussed the information described in the preceding two items in this sublist among themselves without management and outside auditors present.
  - The audit committee in reliance on the review and discussions with management and the outside auditors pursuant to first two items in this sublist believes the company's financial statements are presented in conformity with GAAP in all material respects.
- *Recommendation 10.* The SEC should require that the company's outside auditor conduct a SAS No. 71 Interim Financial Review prior to filing Form 10-Q. Also, SAS No. 71, *Interim Financial Information* (AICPA *Professional Standards,* vol. 1, AU sec. 722), should be amended to

require that a company's outside auditor discuss with the audit committee or least its chairman and a representative of financial management the matters discussed in *Communication with Audit Committees* (AICPA *Professional Standards*, vol. 1, AU sec. 380), prior to filing form 10-Q.

Responding to the Blue Ribbon Committee's recommendations, in October 1999, the NYSE, NASDAQ, and the American Exchange each filed proposed rule changes with the SEC that would amend their rules concerning audit committee requirements.

Help Desk—The above represents only a brief summary of the report's recommendations. It is highly recommended that the report be read in its entirety. The reasons for the recommendations included in the full report can offer some useful insights to auditors, for example, when considering the effectiveness of a client's audit committees (that is, when considering the control environment pursuant to SAS No. 55). The full text of the report can be found at www.nyse.com/press/publications.html or www.nasd.com

Decimalization

Decimalization refers to the conversion of securities from fractional pricing (eighths and sixteenths of a dollar) to decimal pricing (dollars and cents). The SEC has established a timetable for completing this change to decimal pricing with a target conversion date of June 30, 2000. Systems that currently compile, store or display using fractional pricing will need to be converted to reflect decimal pricing.

To prepare for the conversion to decimalization, various industry trade groups as well as SRO have taken active roles in addressing this change and preparing for the conversion. The NASD in its Special Notice to Members No. 99-39, discusses securities industry efforts to prepare for decimalization. Also, the Securities Industry Association has established a Decimalization Steering Committee to review the impact of conversion to decimal pricing, along with four subcommittees: Implementation, Vendor Interface, Testing and Communication, and Regulatory Liaison. A number of issues that have been identified are minimum price variation (MPV), quoting and trading volume, new emerging trading strategies, and capacity issues.

References for Additional Guidance

Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the table at the end of this document. Many nongovernment and some government publications and services involve a charge or membership requirement.

Fax services require users to follow voice cues and request selected documents to be sent by fax machine. Some fax services require the user to call from the handset of the fax machine; others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Many private companies, professional associations, and government agencies allow users to read, copy, and exchange information electronically through the Internet's World Wide Web.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

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This Audit Risk Alert replaces *Securities Industry Developments—1998/99*.

Auditors should also be aware of the economic, industry, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA *General Audit Risk Alert—1999/2000* (Product No. 022250kk).

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066.

The *Securities Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may email these comments to mkasica@aicpa.org or write to:

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APPENDIX

Federal Regulations Related to Money Laundering

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. BSA defines "brokers or dealers in securities registered or required to be registered with the SEC" under the Securities Exchange Act of 1934 as financial institutions.

All securities brokers and dealers and government securities dealers in the United States are required under 17 CFR 240.17a-8 and 17 CFR 405.4 to comply with certain anti-money laundering requirements. The most recent change to these was referenced in NASD-R Notice to Members 96-67 and 97-13 (see the next paragraph) regarding recordkeeping for transmittals of funds. In addition, the New York Stock Exchange, in Information Memorandum 89-5, provided information to its members on reporting suspicious transactions involving money laundering to the government (discussed below).

NASD-R Notice to Members 96-67 and 97-13, *Bank Secrecy Act Recordkeeping Rule for Funds Transfers and Transmittals of Funds* provides information to National Association of Securities Dealers members regarding the Treasury's amendments to the BSA, which facilitate tracing funds through the funds-transmittal process, effective May 28, 1996. For transmittals of funds of $3,000 or more, brokers and dealers of securities are required to obtain and keep certain specified information concerning the transmitter and the recipient of those funds. In addition, broker and dealers must include this information on the actual transmittal order.

Brokers and dealers of securities firms that are not subsidiaries of bank holding companies are not currently required under BSA to report suspicious activity either by employees or by customers to the Treasury Department. However, Treasury has announced that it will be proposing a similar requirement to all securities brokers and dealers. Treasury encourages securities firms to voluntarily file reports regarding suspicions of money laundering and many of them are voluntarily complying with this provision, in anticipation of imminent rules. Securities subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225). The Annunzio-Wylie Anti-Money Laundering Act of 1992 provides a safe harbor from civil liability for reporting financial institutions.

BSA implementing regulations require financial institutions including securities firms to file currency transaction reports (CTRs - IRS Form 4789) for cash transactions greater than $10,000.

Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs - Customs Form 4790) and foreign bank and financial accounts (FBARs - Treasury Form TDF 90-22.1) have not been modified since 1989 and 1987, respectively. However, on January 16, 1997 (see Federal Register), the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

On July 13, 1998, the European Union proposed expanding the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This proposal, if implemented as proposed, would apply to the audits of the European operations and subsidiaries of domestic clients.

The International Organization of Securities Commissions in its "Objectives and Principles of Securities Regulation" obliges member states (Principle 8.5) to require securities firms to "have in place policies and procedures" to reduce the likelihood of money laundering.

For copies of BSA forms mentioned above and more information regarding anti-money laundering issues as they affect securities brokers and dealers, consult the FinCEN Internet site.

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Web Site Address/Electronic Bulletin Board*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 (888) 777-7077 Information about the AICPA's continuing professional education program is available through the AICPA Professional Development Team (menu item 1).	*24 Hour Fax Hotline* (800) 362-5066	www.aicpa.org	
Financial Accounting Standards Board	*Order Department* 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116 (800) 748-0659	*24 Hour Fax on Demand* (203) 847-0700, menu item 14	www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)

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INFORMATION SOURCES *(continued)*

Organization	*General Information*	*Fax Services*	*Web Site Address/Electronic Bulletin Board*	*Recorded Announcements*
Financial Crimes Enforcement Network (FinCEN)	2070 Chain Bridge Road Vienna, VA 22182 (703) 905-3770		www.ustreas.gov/fincen	
Independence Standards Board	1211 Avenue of the Americas 6th Floor New York, NY 10036 (212) 596-6133	(212) 596-6137	www.cpaindependence.org	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4040 *SEC Public Reference Room* (202) 942-8090 (202) 942-8092 (tty)		www.sec.gov	*Information Line* (202) 942-8088
Securities Industry Association	120 Broadway New York, NY 10271-0080 (212) 608-1500	(212) 608-1604	www.sia.com	

New York Stock Exchange Inc.	Eleven Wall Street New York, NY 10005 (212) 656-3000	(212) 656-2126	www.nyse.com	
National Association of Securities Dealers, Inc.	1735 K Street NW Washington, DC 20006-1500 (202) 728-8000		www.nasd.com	
Public Securities Association (The Bond Market Association)	40 Broad Street New York, NY 10004-2373 (212) 809-7000	(212) 440-5260	www.psa.com	
Commodity Futures Trading Commission	Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 (202) 418-5430 (Division of Trading & Markets)	(202) 418-5528	www.cftc.gov	

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INFORMATION SOURCES *(continued)*

Organization	*General Information*	*Fax Services*	*Web Site Address/Electronic Bulletin Board*	*Recorded Announcements*
Futures Industry Association	2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006 (202) 466-5460	(202) 296-3184	www.fiafii.org	
National Futures Association	200 West Madison Street Suite 1600 Chicago, IL 60606-3447 *Information Center* (312) 781-1410		www.nfa.futures.org	